



SEPTEMBER 2024

# THE FISCAL IMPLICATIONS OF PROP. 138

## PROTECTING THE MINIMUM WAGE CREDIT FOR TIPPED WORKERS

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## SUMMARY AND KEY FINDINGS

This November, Arizona residents will decide whether to move the minimum wage credit for tipped workers into the state's Constitution. In Arizona, changes to Constitutional provisions must clear a higher threshold (relative to statutory provisions) before being enacted – including by an affirmative vote of the public.

Under current law, employers are allowed to pay employees who regularly receive tips an hourly wage of up to \$3 less than the prevailing state minimum wage amount, as long as those employees make at least the minimum wage amount once their tipped income is included. If approved by voters, Prop 138 would change this \$3 offset to 25% of the state minimum wage amount, as long as affected employees make at least \$2 above the current state minimum wage.

The minimum wage rate in Arizona is currently \$14.35 per hour (and, correspondingly, the minimum wage for qualifying tipped workers is currently \$11.35/hr), but based on price inflation it will increase to approximately \$14.77/hr in 2025.<sup>1</sup> If Prop 138 is enacted, the tipped worker offset would thus increase from \$3.00 to \$3.69 in 2025 (or a new minimum wage for tipped workers of \$11.08/hr beginning next year).

Wage floors can be especially harmful to younger workers and students – who often work in the food service industry and for tips. A tipped worker credit can mitigate that. Following the repeal of its credit for tipped workers, D.C. restaurants and bars reportedly slashed employment by 12% of their total workforce.

### Key Findings

- CSI estimates that nearly 30% of food service workers may participate in Arizona's minimum wage credit for tipped workers. Despite having a legal wage floor of less than the state's minimum wage, they have average annual earnings of over \$22 per hour.
- Arizona's current credit for tipped workers protects between 6,200 and 13,500 jobs in the state; reduces prices at restaurants and bars by about 1%; and increases state GDP by up to \$1 billion annually.
- The value of the tipped workers credit has fallen precipitously – from over 40% of the hourly minimum wage in 2006 to only about 21% today. Prop. 138 would freeze the credit at a fixed 25% of the hourly minimum wage going forward.
- Rising labor costs, stringent regulations, and other demands on their time have made it more difficult for young people and students to get started in the labor market. In 1990, the teen labor force participation rate was over 50%; today it is approaching just 20%.

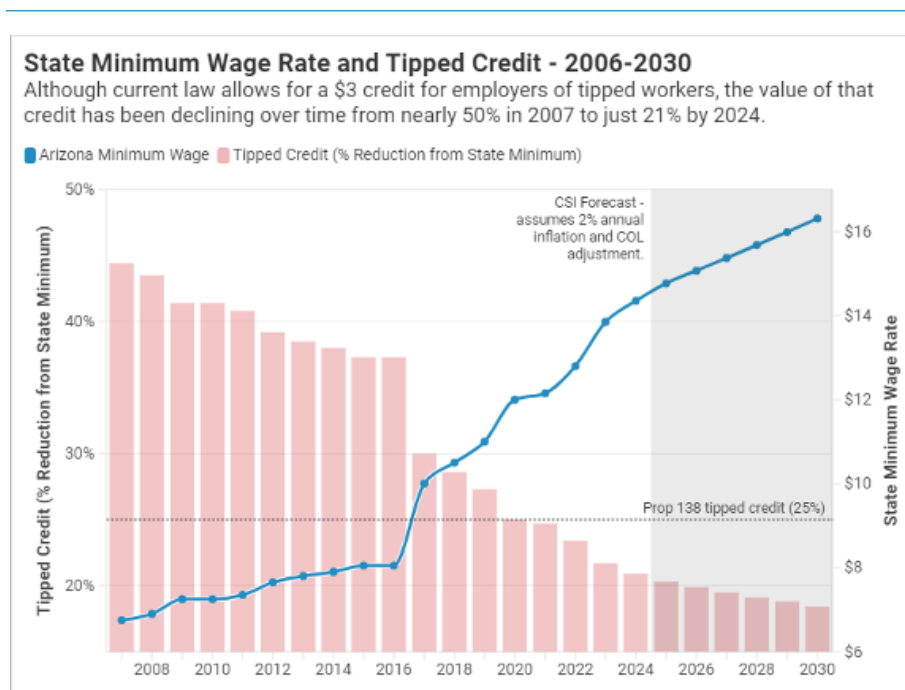
# ARIZONA'S MINIMUM WAGE

In 1938, the United States enacted its first national minimum wage law – the *Fair Labor Standards Act*. The prescribed wage then was \$0.25 per hour, and the Act applied to only a fraction of the American labor force.<sup>ii</sup> Since 2009, the wage has been \$7.25/hour, and the Act applies to nearly all hourly employees in the country.

Today, 30 states – including Arizona – and the District of Columbia prescribe hourly minimum wages above the federal floor.<sup>iii</sup> In 2006, Arizona voters approved Prop. 202, which established a separate state minimum wage (which at the time exceeded the federal minimum by \$1.60/hr).<sup>iv</sup> The Act also provided – for the first time ever in Arizona – an annual adjustment to the statutory wage floor for cost of living (as measured by the Consumer Price Index).

In 2016, Arizona voters approved Prop. 206 – which among other things increased the minimum wage incrementally to \$12.00/hr, while retaining an annual inflation adjustment thereafter. Prop. 206 also continued Arizona’s existing credit for tipped workers – an allowance under federal law. Arizona’s tipped worker credit today allows employers to pay qualifying tipped workers up to \$3/hr less than the state minimum wage, if the sum of their cash wage plus tips is at least equal to the minimum wage.

**FIGURE 1**



As a percentage of the statutory minimum wage, the value of this fixed credit has declined over time – from nearly half of the minimum wage in 2007 to just 21% of the current state minimum. Without Prop. 138, the value of the credit would continue to decline going forward; if approved by voters, though, the credit would hereafter be fixed at 25% of the hourly minimum.<sup>v</sup>

Under the so-called *Voter Protection Act*, provisions of state law approved by voters after 1998 cannot be changed without either another popular vote or a three-fourths majority of both the Arizona State House and Senate (and then only if the change “furthers the purpose” of the law). Arizona’s minimum wage – including its credit for tipped workers – is subject to voter protection.

As of 2023, 43 states allow some kind of credit towards their minimum wage for tipped workers. Though ultimately not qualified for the ballot<sup>vi</sup>, the proposed Prop. 212 in Arizona propositioned repealing the state’s credit for tipped workers and raising the statewide minimum wage to \$18 per hour.<sup>vii</sup>

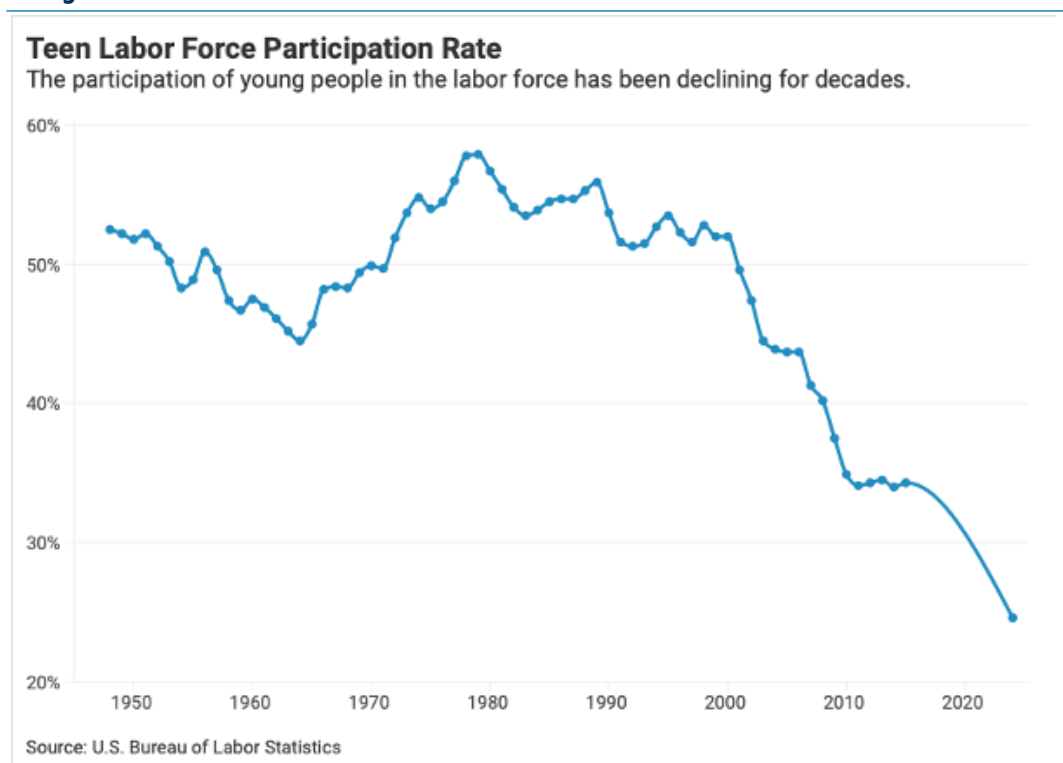
## WHO ARE MINIMUM WAGE EARNERS

According to federal data, fewer than 2% of hourly workers nationwide were making the federal minimum wage in 2019.<sup>viii</sup> In 2022 and based on Census data, CSI estimates that fewer than 10% of Arizona workers were making at or below the equivalent of a full-time annual Arizona minimum wage.<sup>ix</sup>

According to the Bureau of Labor Statistics, 45% of workers making at or below the minimum wage in 2022 were under age 25 (versus 20% for the overall labor market) and 47% of minimum wage earners were either high school graduates or hadn't even completed high school as their highest educational attainment.<sup>x</sup>

Together, this data suggests that minimum wage earners are both younger and disproportionately likely to be students. For many young workers, minimum wage jobs become their first entry into the formal labor market. In fact, a 2014 study by *FiveThirtyEight* observed that about half of minimum wage earners (equivalent to an annual income of about \$15,000 at the time) lived in households making over \$40,000 per year – meaning for many households with at least one minimum-wage earner, that earner alone probably isn't the primary source of income.<sup>xi</sup> Only about 18% of households with a minimum-wage earner were making \$15,000/year or less (or what you would expect from a single-adult householder at the floor).

Figure 2



# THE ECONOMIC IMPLICATIONS OF WAGE FLOORS

In general, economics research supports the basic theory of demand: when the price of something rises, the quantity demanded falls.<sup>xii</sup> This principle extends to the demand for workers by firms; if the price of labor is higher, businesses can be expected to hire fewer workers and reduce the hours for those they do hire.

Businesses will also prioritize their least productive workers when making hiring decisions under a price floor (like a minimum wage). For example, they are more likely to reduce the share of their workforce that is younger, less educated, and especially that are students or have other personal issues that may make them relatively more difficult to accommodate in a traditional workplace.<sup>xiii</sup>

This means that minimum wages will have disproportionate impacts depending on the baseline characteristics of particular industries. The restaurant industry has historically relied on a workforce that skews heavily towards exactly such a demographic. One-third of all Americans report that their first jobs were in that industry.<sup>xiv</sup> Forty percent of its workers are under the age of 25 and sixty percent are under 35.<sup>xv</sup> Moreover, this industry is a heavy user of both the minimum wage and tips; 60% of all tipped workers work in the restaurant and bar industry.<sup>xvi</sup> CSI assumes that most of these workers are earning at or near the current Arizona state minimum wage, including the tipped workers credit of \$3/hour

(for an effective hourly wage of \$11.35). According to federal occupational wage data, the median hourly wage for servers and bartenders in Arizona is over \$21/hour – implying that in general, the median tipped restaurant worker is earning the equivalent of nearly \$10 per hour in tips (or well over the state \$3/hour credit requirement).<sup>xvii</sup>

Given Arizona's unusually high statutory state minimum wage (currently the 5th highest in the country), and the reliance of industries like restaurants and bars on customer tips to supplement relatively lower hourly wages to keep costs down, Arizona's tipped-workers credit is especially relevant.

The research consensus is clear: higher minimum wages, or the elimination of credits against high minimum wages, not only may not increase earnings but it may in fact hurt the earning and employment prospects of particularly vulnerable groups (the young, students, etc.).<sup>xviii xix xx</sup> While a general price elasticity of demand for labor might be -0.1 (implying a 1% increase in minimum wages might be correlated with an overall decline of 0.1% in the demand for labor), the elasticity of demand for minimum-wage workers in tip-dependent industries like restaurant and bars may be much higher.<sup>xxi</sup> For example, following the prospective repeal of its tipped workers credit restaurants and bars in the District of Columbia reportedly slashed 12% of their total workforce.<sup>xxii</sup>

## What Would the Loss of Arizona’s Tipped Workers Credit Do?

Given the dueling proposals voters may have had to consider this year – one repealing and the other placing in the state Constitution Arizona’s current credit for tipped workers – and the theoretical implications of wage floors, the question becomes: what are the practical effects (if any) of Arizona’s current tipped workers credit?


Again in summary, current Arizona law provides a credit of up to \$3 per hour against the state minimum wage for certain tipped workers, if their tipped earnings bring them up to at least the minimum wage. If approved by voters, Prop. 138 would increase the credit to 25% of the statutory minimum wage, but also require that the workers earnings after tips are at least equal to the state minimum wage plus an additional \$2 (e.g., approximately \$17 per hour next year).

While the credit is not specific to the restaurant and bar industry, it does impose specific requirements on employers with respect to both the volume and tracking of tips that makes it likely to have its use concentrated in that industry. For purposes of the following analysis, CSI assumes that its repeal would only directly impact wages and business costs within the restaurant and bar industry; to the extent its impact is substantially broader, our results would underestimate the implications on other industries.

To analyze the economic impact of eliminating Arizona’s credit for tipped workers, CSI relied on the REMI Tax-PI dynamic input-output model. The model uses the dynamic relationships between businesses, households, and governments to understand the fiscal implications of proposed policy changes. To model the potential impacts of minimum wage changes in the absence of a credit for tipped workers, our analysis assumed an increase in wage costs (and, therefore, take-home pay for impacted workers – notably we did not assume that tipping would decline under our baseline scenario), and an offsetting decrease in business income (accruing to proprietors and capital-owners through dividends and other returns-to-capital) to maintain the firms binding budget constraint. We use both a baseline model – which tries to directly capture the effects of a statutory minimum wage increase for restaurant workers – and an alternative, more aggressive model based on the price elasticity of labor demand implied by economic literature.

### THE TIPPED WORKER’S CREDIT BY THE NUMBERS

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**6,200 - 13,500**  
ARIZONA JOBS PROTECTED BY THE CREDIT

**\$500 MILLION - \$1 BILLION**  
ANNUAL INCREASE IN STATE GDP

**30%**  
SHARE OF FOOD SERVICE EMPLOYMENT BENEFITING FROM THE CREDIT

**\$22.04/HR**  
EST. AVERAGE HOURLY WAGE OF TIPPED FOOD SERVICE WORKERS

The analysis assumed affected workers would see their hourly base wage increase by \$3 (or approximately 25%, excluding tips and other non-base compensation), and that the proposal would affect all bartenders and servers, and approximately half of all dining room attendants and helpers, hosts and hostesses, and lounge and coffee shopworkers within the restaurant and bar industry (as tracked and reported by the Bureau of Labor Statistics<sup>xxiii</sup>). For context, our estimate of current total employment affected in Arizona is 85,250 workers – or 29.6% of the approximately 287,930 restaurant and bar workers in the state. The current average hourly total wage for these workers (including tips) is \$22.04, for an effective hourly increase in labor costs for affected occupations of 11.59% (or 3.43% for the industry as a whole).

After accounting for assumed non-base compensation costs to employers (benefits, overhead, etc.) of 27.5%<sup>xxiv</sup>, this analysis assumes an offsetting decrease in business income of \$588 million.

**The initial response in Arizona to the removal of its tipped workers credit is the loss of 6,200 jobs – including nearly 1,500 jobs in the food service industry specifically.** The overall consumer price level rises by 0.06%, and prices in restaurants and bars increase by over 1%. State Gross Domestic Product (GDP) declines by \$500 million, and Personal Income falls by approximately \$700 million – implying that the increases in expected compensation for tipped workers are more than fully offset by broader job and economic losses. As a reminder: this model assumes there is no decrease in propensity to tip in response to either the higher base wage or higher prices.

Over the following decade, the economy adjusts to the relatively higher costs of food service by shifting production demand in that industry towards capital and away from labor (e.g., automation) and by shifting overall demand away from food services and towards other establishments. By 2030, expected aggregate statewide job losses relative to the economic baseline have decreased to -5,265, but job losses in the restaurant and bar industry specifically have increased to -1,935.

Notably, this model output suggests our analysis relies on a relatively conservative set of macroeconomic assumptions with respect to the policy change. For reference, we can compare our modeled outcome to that which comes from an assumed 2.64% decline in total restaurant and bar industry employment implied by a -0.1 price elasticity of labor demand (or the low end of the range of plausible values implied by our literature review). If 2.64% of restaurant service jobs were lost, this would be an immediate employment loss of over 7,600 jobs.

In this case, a REMI output analysis of the immediate loss of 7,610 food service industry jobs increases statewide aggregate employment losses to 13,515 – and increases to 13,947 jobs over the following decade. State GDP losses under this scenario approach \$1 billion/year by 2030, and the food service industry sheds nearly 12% of its total tipped employees.

If we regard our baseline estimate as conservative and on the lower end of the likely impact having a tipped worker's credit provides the Arizona economy, then this alternative approach can provide a plausible upper bound.



## THE BOTTOM LINE

While a minimum wage may be seen as an effective means of improving the standard of living for lower income households, the reality of wage floors is more complicated: the costs for workers and consumers can easily exceed any improvements in earnings for impacted workers. Minimum wage policy has long recognized that this is especially true for certain categories of workers, like the young and tipped workers, which is why there are often credits against the minimum wage for them.

Arizona's credit for tipped workers likely increases statewide employment by between 6,200 and 13,500 jobs, reduces restaurant and bar prices by over 1%, and increases state GDP by up to ~\$1 billion per year.

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